Supreme Court, U.S.
FILED
AUG 31 1992
OFFICE OF THE CLERK

No. 92-212

In the Supreme Court of the United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC, PETITIONER

v.

FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether, as applied (i) to a domestic corporation that has a foreign parent or (ii) to a foreign corporation that has a foreign parent or foreign subsidiaries, California's use of the worldwide formula apportionment method to allocate income for tax purposes violates the Commerce Clause of the Constitution.

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INTEREST OF THE UNITED STATES

The Constitution confers upon Congress the power to "regulate Commerce with foreign Nations" (Art. I, § 8, Cl. 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties" (Art. II, § 2, Cl. 2). The United States has a substantial interest in cases that address the constitutional allocation of authority over matters affecting foreign commerce and foreign relations. This case presents such an issue.

As this Court recognized in *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 184-193 (1983), the United States employs the arm's length method

for allocating income among commonly controlled corporations. This method, which reflects the consistent practice of all major trading Nations, is also required, for federal taxation, by numerous tax treaties to which the United States is a party. California's use of the worldwide combined reporting method for allocating income among a unitary group of multinational corporations conflicts with this uniform international practice and has created an irritant in the commercial relations of the United States and its major trading partners. The Departments of State and Treasury inform us that foreign governments have objected to California's departure from accepted international tax practice and have threatened (or enacted) retaliatory legislation against United States corporations as a result of California's unilateral actions. The State's tax has thus seriously undermined the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments." *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976).

STATEMENT

1. Two different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, doing business with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal Revenue Code and is a central feature of

the many bilateral tax treaties to which the United States is a party (Pet. App. F44). The separate accounting method is also the accepted international standard.[1] It is almost universally applied by foreign tax systems and has been incorporated in the model tax treaties adopted by the United Nations and the Organization for Economic Cooperation and Development (*ibid.*).[2]

The other method of allocating corporate income among taxing jurisdictions is the "worldwide combined reporting" method used by California and two other States. For corporations engaged in a unitary business, California ignores the separate corporate existence of parents, subsidiaries and affiliates, pools their income together, and allocates a portion of that

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[1] The international practice is described in the letter to Governor Deukmejian of California, dated January 30, 1986, from Secretary of State George P. Shultz (Pet. App. F44-F46). See also G. Maisto, *General Report*, in 77a *International Fiscal Ass'n, Cahiers de droit fiscal international (Transfer Pricing in the Absence of Comparable Market Prices)* 19-75 (1992). Maisto notes that the arm's-length method is the primary method for allocating income internationally and that the OECD considers the combined reporting and formula apportionment method of allocating income to be arbitrary. *Id.* at 50-51. Other than in a few States of the United States, the worldwide combined reporting method is not used at the national or sub-national level by the United States or any of its major trading partners or in any of the countries surveyed. *Ibid.*

[2] See OECD Model Double Taxation Convention on Income and on Capital, Art. 7 (1977); Organization for Economic Cooperation and Development Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979); United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Pub. No. ST/ESA/102, Art. 7 (1980).

combined income to California based upon a multi-factor apportionment formula.[3] See *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 162-163 (1983). California applies its worldwide combined reporting method not only to domestic parent corporations that have foreign subsidiaries (see *ibid.*) but also to domestic subsidiaries (conducting business in California) that have foreign parents and to foreign parents (conducting business in California) that have foreign subsidiaries.

California's application of the worldwide combined reporting method of taxation to corporations doing business in California that have foreign parents or foreign affiliates conflicts with the "separate accounting" method applied under federal law and under established international practice. In letters addressed to the governors of the six States that then employed the worldwide combined reporting method of taxation (Alaska, California, Idaho, Montana, New Hampshire and North Dakota), the Secretary of State expressed the concern of the United States that state use of worldwide combined reporting "is at odds with the position of the United States and has become a source of conflict with foreign states" (Pet. App. F45). The Ambassadors of Australia, Belgium, Canada, Denmark, France, the Federal

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[3] Under the three-factor apportionment formula used by California, the in-state corporation's income is calculated as a percentage of the total income of the group of related corporations. After the unitary business group is identified, the in-state corporation's sales, property, and payroll are expressed as a fraction of the total sales, property, and payroll of the unitary group. These three fractions are arithmetically averaged. This average is then multiplied against worldwide group income to yield the taxable income of the in-state corporation (Pet. App. A5).

Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands and Switzerland have advised the United States that the worldwide combined reporting method of taxation constitutes "a serious obstacle to the further development of our trade and investment relationships" (Pet. App. F45). In particular, the United Kingdom enacted legislation in 1985 that provides for retaliatory tax treatment of United States corporations that operate in the States that apply the worldwide combined reporting method.[4] While the United Kingdom has not yet invoked this legislation,[5] its enactment provides clear indication of the adverse impact that California's method of taxation has on the conduct of foreign economic relations by the United States.

2. The taxpayers involved in this case are Barclays Bank International Limited (BBI) and Barclays Bank of California (Barcal). During 1977, Barcal (a United States corporation conducting banking activities in California) was a wholly owned

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[4] The United Kingdom legislation denies tax credits on the taxes owed by such corporations for dividends they receive from their United Kingdom subsidiaries. See Finance Act 1985, Pt. II, ch. I, § 54, and Sch. 13, ¶ 5 (Eng.), reenacted without substantial change in Income and Corporation Taxes Act 1988, Pt. XVIII, ch. III, § 812 and Sch. 30, ¶¶ 20 and 21 (Eng.). See also Parliamentary Debates (Hansard) 1014-1018 (10 July 1985); Secretary of State Shultz's letter to Governor Deukmejian (Pet. App. F46).

[5] The United Kingdom has stated that the legislation will not apply to dividends paid on or before December 31, 1989. See Joint Report by Inland Revenue and U.S. Treasury, *Unitary Tax: Review of Progress Towards Resolving the Problems*, para. 6.2 (Dec. 1991).

subsidiary of BBI (a United Kingdom corporation conducting an international banking business).[6] Both BBI and Barcal did business in California and were therefore subject to tax in that State (Pet. 3, 4; Pet. App. C36-C38).

In computing its California income tax for 1977, Barcal used the separate accounting method and reported only the income it earned from California sources. In computing its California income tax for 1977, BBI reported not only the income it earned from California sources but also included (i) income BBI earned from operating bank agencies and branches in the United Kingdom and approximately 33 nations or territories outside of the United Kingdom and (ii) the income earned by 70 subsidiaries (including Barcal) of BBI operating in 34 nations or territories outside of the United Kingdom. BBI did not, however, include the income of BBI's parent (see note 6, *supra*) or of the parent's subsidiaries. Thus, neither Barcal nor BI submitted its California tax return under the worldwide combined reporting method required by California (Pet. 7-8; Pet. App. C38-C41).

The California Franchise Tax Board determined that Barcal and BBI were members of a worldwide unitary business conducted by all members of the Barclays Group. That Group included (i) Barcal, a wholly owned subsidiary of BBI doing business only

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[6] BBI was a wholly owned subsidiary of Barclays Bank Limited, a United Kingdom corporation. In 1982, Barclays Bank Limited changed its name to Barclays Bank PLC, which is named as the petitioner in this case (Pet. 2-3).

in California; (ii) BBI, a United Kingdom Corporation doing general retail and commercial banking in the United Kingdom and 34 other nations or territories outside the United Kingdom, including California; (iii) the subsidiaries of BBI in which BBI has more than a 50% interest; (iv) Barclays Bank Limited, a United Kingdom corporation which conducts no business in California and which owns 100% of the stock of BBI; and (v) the subsidiaries of Barclays Bank Limited in which that corporation holds more than a 50% interest. The California Franchise Tax Board calculated the tax owed by BBI and Barcal by allocating a portion of the total income of the above unitary group to these two taxpayers utilizing a three-factor apportionment formula. The State's calculation indicated a tax deficiency, which the Board then assessed (Pet. 7-8; Pet. App. C38-C40).

3. Barcal and BBI challenged the State's assessment because it was based not only on the income that they had separately earned but also on the income of their foreign parent and other related foreign subsidiaries which do no business in California or elsewhere in the United States. After paying the assessments, the taxpayers sued for a refund in California superior court (Pet. App. C38-C41).

The trial court entered judgment in favor of the taxpayers (Pet. App. C1-C34). The court concluded that California's computation of taxes by use of worldwide combined reporting improperly included income earned by foreign parents and affiliates of the taxpayers. The court held that this violated the Commerce Clause of the United States Constitution because it impeded the federal government's ability to speak with one voice in the conduct of foreign

affairs (*id.* at C23-C26), impermissibly discriminated against foreign commerce (*id.* at C26-C28) and violated due process (*id.* at C29-C30).[7]

The California court of appeal affirmed (Pet. App. B1-B37). The appellate court held that California's application of worldwide combined reporting to the income received by foreign parents and affiliates of the taxpayers violated the Commerce Clause because it frustrated the United States' ability to speak with one voice in an area of foreign affairs where federal uniformity is necessary (*id.* at B35).

The California Supreme Court reversed, upholding the constitutionality of the tax under the Commerce Clause as applied in this case. The court relied extensively on the fact that, while Congress has been given many opportunities, it has not enacted legislation to prohibit the States from employing the worldwide combined reporting method to multinational corporations (Pet. App. A28-A31). Concluding from "the din" of this legislative "silence" that Congress "has decided *not* to prohibit state use" of worldwide combined reporting "in cases of this kind" (*id.* at A26), the court declined to apply the Commerce Clause to prohibit the State from enforcing a tax that Congress has not acted affirmatively to prohibit (*id.* at A24-A38).

Since the court of appeal had resolved the case solely under the Commerce Clause, and had not reached petitioner's separate due process challenge to the State's

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[7] The trial court concluded that procedures adopted to implement the State's worldwide combined reporting method violate due process because, "with customarily and currently available acounting data, literal compliance with [their] requirements is impossible for foreign multi-nationals" (Pet. App. C29).

tax (see note 7, *supra*), the California Supreme Court remanded the case to the court of appeal for further proceedings on that issue (*id.* at A39-A40).

ARGUMENT

In *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983), the Court held that California's use of the worldwide combined reporting method for allocating the income of a unitary business did not violate the Commerce Clause. *Id.* at 184-197. That case, however, concerned application of the worldwide combined reporting method to a domestic parent corporation doing business in California. Recognizing the potentially different and additional considerations involved when the incidence of a state tax falls on a *foreign* corporation, the Court expressly reserved the question whether the California method would be constitutional "with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." *Id.* at 189 n.26.

This case presents the question that was expressly reserved in *Container Corp.* This Court's resolution of this important question is necessary to avoid continued state action that conflicts with accepted international commercial practice and prevents the United States "from speaking with one voice when regulating commercial relations with foreign governments" (*Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979)).

1. Under the Commerce and Due Process Clauses of the United States Constitution, a State, when imposing an income-based tax, may not tax value earned outside its borders. *Allied-Signal Inc.* v. *Director, Division of Taxation*, 112 S. Ct. 2251, 2255, 2258

(1992). The State may, however, constitutionally tax on an apportioned basis the income earned by a corporation in multiple taxing jurisdictions. *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 164-165. The income to be apportioned must, however, be related to the business carried on in that State. *Allied Signal, Inc.* v. *Director, Division of Taxation*, 112 S. Ct. at 2263. For a tax imposed on an apportioned basis to satisfy the basic requirements of the Commerce Clause, (i) there must be a substantial nexus between the State and the activity or property taxed, (ii) the activity or property must be fairly apportioned to the taxing State, (iii) the tax must not discriminate against interstate commerce, and (iv) the tax must be fairly related to the services provided by the State. *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. 1, 8 (1986); *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 165-171. When the state tax affects foreign commerce, two additional questions must be addressed: "first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments." *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. at 8 (quoting *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979)). See also *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 185-187. "If a state tax contravenes either of these [two additional] precepts, it is unconstitutional under the Commerce Clause." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. at 451.

The Court observed in *Container Corp.* that "a state tax at variance with federal policy will violate

the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." 463 U.S. at 194. The "most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Ibid.*

In *Container Corp.*, this Court considered the constitutionality of California's application of the worldwide combined reporting method to determine the income of members of a unitary corporate group controlled by a domestic parent corporation. Noting that the United States had not filed a brief in that case (463 U.S. 195-196 and n.33)[8] and that there was no suggestion that foreign retaliatory acts would stem from California's taxation of domestic parent corporations (*id.* at 195), the Court concluded that California's tax as applied to members of domestic multinational corporations did not seriously threaten the foreign policy of the United States and thus did not violate the Commerce Clause. The Court, however,

[8] At the time *Container Corp.* was considered by the Court, there was another case (*Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349) before the Court that presented virtually the same issue. The United States had submitted an amicus brief and participated in the oral argument in *Chicago Bridge*, taking the position that a similar Illinois tax involving a domestic corporation with foreign subsidiaries violated the Commerce Clause. After argument, the Court ordered *Chicago Bridge* carried over to the next Term, but did not schedule that case for reargument. Instead, it scheduled and heard argument in *Container Corp.* The Members of the Court disagreed as to what position the United States took with respect to *Container Corp.* See 463 U.S. at 195-196 & n.33; *id.* at 204 (Powell, J., dissenting).

recognized that the result may be different when the "incidence of the tax" (*ibid.*) falls on a foreign-controlled corporation. See *id.* at 188. The Court therefore expressly reserved judgment as to whether the tax would be constitutional as applied to members of a foreign-controlled corporate group. *Id.* at 189 n.26.

When, as in the present case, the State applies its worldwide combined reporting method to compute the state income tax of members of a foreign unitary corporate group, application of the tax creates an impediment in the relations of the United States with its trading partners and implicates foreign commerce concerns that are the exclusive province of the federal government. As this Court recognized in *Container Corp.*, 463 U.S. at 184-193, the arm's-length standard is the international norm for allocating income among controlled corporations across international boundaries and the method used by the United States for allocating income for federal income tax purposes. The method used by California is at odds with this accepted international practice. California's use of its inconsistent method of taxation has created serious tensions in the federal government's conduct of commercial relations with its trading partners and led to the enactment of retaliatory legislation (Pet. App. F44-F47). See p. 5, *supra*. California's application of its worldwide combined reporting method of taxation to compute the income tax of members of foreign-controlled unitary corporate groups violates the Commerce Clause under this Court's analysis in *Container Corp.* because California's unilateral action departs from an accepted international practice to which the United States adheres and prevents the United States from speaking with one voice on this sensitive and im-

portant matter of foreign commercial relations. See 463 U.S. at 185-189, 193-196.

2. The California Supreme Court did not test California's method of apportioning income in this case under the analysis set forth in *Container Corp.* because the court concluded (Pet. App. A39) that *Wardair Canada Inc.* v. *Florida Department of Revenue* imposed a new, preliminary hurdle to the taxpayer's argument. *Wardair* involved a challenge by a Canadian-based international air carrier to a state sales tax on fuel purchased in Florida for flights operating between Florida and Canada. The Court found "no threat of multiple international taxation * * * since the tax [was] imposed only upon * * * a discrete transaction which occurs within one national jurisdiction only" (477 U.S. at 9). Nor did the Court find any evidence that imposition of the sales tax in that case violated any international norm. *Id.* at 10. To the contrary, the Court concluded that numerous bilateral agreements to which the United States was a party were "understood * * * to permit this sort of taxation" and therefore "show that the Federal Government has affirmatively decided to permit the States to impose these sales taxes on aviation fuel." *Id.* at 12. Finding such "affirmative[]" approval of the state tax, the Court found "no need * * * to consider * * * whether, in the absence of these international agreements, the Foreign Commerce Clause would invalidate Florida's tax." *Id.* at 13.

California claims that this case is like *Wardair* because the United States is a party to numerous bilateral tax treaties that set forth agreements with respect to national-level taxation but do not address state or sub-national taxation (Pet. App. A34). Cali-

fornia relies specifically on the history of the 1975 tax convention between the United States and the United Kingdom (*id.* at A30-A31). As originally presented to the Senate for advice and consent to ratification, that treaty contained a provision (Article 9(4)) that required sub-national taxation to be consistent with the arm's length standard. See Convention Between United States and United Kingdom for Avoidance of Double Taxation, Dec. 31, 1975, 31 U.S.T. 5670, 5677, T.I.A.S. No. 9682. Although a majority of the Senate voted in favor of the treaty, less than the required two-thirds of the votes were obtained for ratification. 124 Cong. Rec. 18,669-18,670 (1978). In a subsequent vote, however, the treaty was approved subject to a reservation that Article 9(4)) would not apply "to any political subdivision or local authority of the United States" (*id.* at 18,416). See *id.* at 19,076. The California Supreme Court concluded from this history (Pet. App. A29-A30) that the Senate's action represents "affirmative" approval of the California tax under the analysis of this Court in *Wardair*.

The contrasts between this case and *Wardair* are striking. In *Wardair*, the Court found that numerous treaties had been made that were "understood" by the participants "to permit" state sales taxation to proceed. 477 U.S. at 12. That "understanding" was supported by the fact that there was no international norm precluding that type of state taxation. *Id.* at 10-11. In this case, by contrast, there is a well-established international practice precluding the State's contrary tax system,- a practice that the Executive has steadfastly honored and that a majority of the Senate voted to implement. Far from representing acquiescence through silence, this his-

tory of Executive and Senate action reflects the thoroughly national character of this issue and the need for federal-level, rather than state-level, disposition of the matter.

Unless this Court concludes that a minority of the Senate can determine the "affirmative" policy of the federal government, it cannot conclude that Senate action on federal tax treaties exhausts the scope of the national power to regulate foreign commerce. The Commerce Clause recognizes that there are matters affecting our foreign commercial relations that inherently require a national solution so that the United States may speak with one voice in its dealings with other Nations. That Congress has not yet crafted a solution to the problem does not mean that the choice of solutions has been left to the separate action of the several States. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 194.[9]

This Court's resolution of the question presented in this case is of great importance because the analy-

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[9] In *Container Corp.*, the Court reviewed much of the same treaty history and legislative proposals considered by the California Supreme Court in this case. See 463 U.S. at 196-197. The Court noted that Congress has "long debated, but has not enacted, legislation designed to regulate state taxation of income." *Id.* at 197 (quoting *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425, 448 (1980)). As a result, the Court concluded that there was no "explicit directive" (463 U.S. at 197) limiting the State's ability to assess the tax at issue in *Container Corp.* That conclusion, however, did not remove the necessity of also considering whether the State's tax was unconstitutional because it would interfere with the conduct of foreign relations and prevent the federal government from speaking with one voice in the regulation of foreign commerce. See *id.* at 194-196. To the contrary, the Court made clear that *both* inquiries were necessary. See *ibid.*

sis applied by the California Supreme Court threatens broad impact on the constitutional allocation of authority to the federal government to regulate foreign commerce. Treaties often may stop short of addressing all aspects of commercial relations. Congress may also decline to enact legislative proposals disposing of similar problems. The fact that treaties and legislation have not provided a binding solution does not mean that the States are empowered independently to resolve politically sensitive matters affecting our international commercial relations.

CONCLUSION

If the Court concludes that it has jurisdiction (see Pet. 26-28), the petition for a writ of certiorari should be granted.

Respectfully submitted.

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AUGUST 1992

☆ U. S. GOVERNMENT PRINTING OFFICE: 1992 312324 60021